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No. 86-1201

In the Supreme Court of the United States

OCTOBER TERM, 1986

VAHLSING CHRISTINA CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioner contends that its receipt of cash upon redeeming stock it held in Texas Plastics, Inc., should have been treated as a tax-free component of a corporate reorganization, rather than as the occasion for the realization of taxable income.

1. Petitioner is one of several corporations that were owned by members of the Vahlsing family. In the mid-1960s, the Vahlsing family decided to reduce the number of corporations through which it conducted its various businesses. As of July 25, 1966, petitioner directly owned 31.4% of the 317,989 outstanding shares of stock of Texas Plastics, Inc. On that date, petitioner purchased from one of its wholly-owned subsidiaries, F.H. Vahlsing, Inc. (Texas), an additional 197,000 shares of Texas Plastics stock at a price of $677,682. That gave petitioner a 93.3% interest in Texas Plastics. At the same time, petitioner purchased from Texas Plastics 490,000 shares of stock in Texas Polymer Corp., another Vahlsing family company, at a price of $490,000. That gave petitioner a 93.3% interest in Texas Polymer. Pet. App. 8a-12a.

On August 29, 1966, in the transaction whose tax consequences are at issue here, Texas Plastics paid petitioner $419,680 in redemption of 122,000 of petitioner's shares of Texas Plastics stock. That reduced petitioner's interest in Texas Plastics from 93.3% to 89.2% (Pet. App. 10a). In June 1967, F.H. Vahlsing, Inc. (Texas) was merged into petitioner. In July 1967, Texas Polymer was merged into Texas Plastics. Pet. App. 8a-12a.

The Commissioner determined that the cash received by petitioner upon the August 29, 1966, redemption of the Texas Plastics stock gave rise to dividend income on petitioner's part pursuant to Sections 301 and 302 of the Internal Revenue Code.[1] As a result of realizing that dividend income, petitioner became a "personal holding company" (see I.R.C. § 542) for the taxable year ending June 30, 1967. Petitioner therefore became liable for the personal holding company tax imposed by Section 541 of the Code. Pet. App. 7a-8a.

2. Petitioner sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's position that petitioner was liable for the personal holding company tax (Pet. App. 7a-25a). The Tax Court concluded that the redemption had resulted in no meaningful reduction in petitioner's percentage of ownership of Texas Plastics and that it therefore was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code (Pet. App. 18a). See *United States* v. *Davis*, 397 U.S. 301 (1970). The court also stated that the redemption could not be viewed as an essential step in an integrated corporate reorganization, finding it more likely that the redemption was undertaken to replenish petitioner's cash reserves (Pet. App. 24a). The Tax Court accordingly concluded that "the redemption, carried out almost a full year before the merger, must be viewed as a

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

transaction separate from the merger and that it was a transaction which independently gave rise to the tax consequences as determined by [the Commissioner]" (*ibid.*).

Subsequently, the Tax Court denied a motion for reconsideration filed by petitioner (C.A. App. 41-42). The court stated there that, even if it were to accept petitioner's claim that the redemption was in pursuance of a plan of reorganization, petitioner's receipt of the $419,680 would not escape recognition under Section 354 of the Code, as petitioner claimed. The court noted that Section 354 applies only to exchanges of "stock or securities" pursuant to a plan of reorganization, whereas petitioner exchanged stock in Texas Plastics for $419,680 in cash. The court therefore concluded that, if the $419,680 were not taxable as a dividend under Section 302(b)(1), it would be taxable as a dividend under Section 356 of the Code (C.A. App. 41).

The court of appeals unanimously affirmed in an unpublished opinion (Pet. App. 1a-4a). The court held that the cash petitioner received on the redemption of its Texas Plastics stock was subject to tax even if, as petitioner maintained, the redemption were considered a necessary step in a corporate reorganization (*id.* at 2a).[2] The court noted that Section 354 of the Code limits nonrecognition of gain in a corporate reorganization to exchanges of stock or securities for other stock or securities and does not extend to exchanges of stock for cash (Pet. App. 2a). The court further observed (*id.* at 3a-4a) that petitioner had cited no authority to support collapsing the various Vahlsing maneuvers and "allow[ing] the elevation of substance over form with regard to" the cash-for-stock transaction.

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[2] The court of appeals therefore found no need to address the Tax Court's alternative holding that the $419,680 was taxable to petitioner under the redemption provisions because the redemption was not a "necessary" part of the reorganization (Pet. App. 2a n.1).

The court therefore concluded that the outcome was governed by this Court's injunction that, " 'while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not.' *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)."

3. Petitioner contends (Pet. 10-13) that the Commissioner was bound to ignore, for income tax purposes, the cash payment received upon the redemption of the Texas Plastics stock because that payment "was an interim transitory step in a reorganization transaction." There are a number of threshold problems with this contention. First, it is by no means clear that a taxpayer who has deliberately chosen to structure a transaction in a particular way may invoke the "step transaction" doctrine in an effort to avoid the adverse tax consequences that attend the form he has chosen. Second, it is by no means clear that the several transactions undertaken by the various Vahlsing corporations added up to a "reorganization" as defined in Section 368.[3] Third, even if petitioner did participate in a "reorganization," it is by no means clear that the redemption at issue, which preceded the merger by a year, should be treated as part of the "plan of reorganization." Fourth, even if the redemption were viewed as part of the "plan of reorganization," it is by no means clear that it was a necessary part, since, as the Tax Court pointed out (Pet. App. 23a), there was no reason why Texas Polymer could not have been merged into Texas Plastics *before* the re-

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[3] Petitioner relied on various subsections of Section 368 at trial. See Pet. App. 18a & n.7.

demption, at which point petitioner conveniently owned identical 93.3% interests in each subsidiary.[4]

In any event, even if one assumes that petitioner could surmount all of these threshold obstacles, the court of appeals was clearly correct in holding that there would still be no basis for treating petitioner's receipt of the $419,680 as a nontaxable event. The nonrecognition afforded reorganizations by Section 354(a)(1) of the Code extends only to "stock or securities" received in exchange for "stock or securities." Section 356(a)(1) of the Code provides that if, in connection with a corporate reorganization, a shareholder receives stock in a corporation that is a party to the reorganization and also "other property or money," the shareholder must recognize the gain realized in the transaction in an amount not in excess of the value of that money or other property. Accordingly, as the court of appeals held, there is no basis upon which the cash received by petitioner for the redemption of its Texas Plastics stock may escape taxation.[5]

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[4] Petitioner contends (Pet. 13-15) that the redemption did not need to be a "necessary" step in the reorganization in order for the "step transaction doctrine" to apply. As petitioner itself acknowledges (Pet. 13), however, the court of appeals explicitly did not reach this issue. Rather, it assumed that the redemption was a necessary step in the reorganization (Pet. App. 2a n.1), and therefore it expressed no view on whether petitioner's contention would be foreclosed if the redemption were not "necessary." This case accordingly presents no occasion to decide whether a step must be a "necessary" one in order for the "step transaction" doctrine to apply.

[5] Neither Section 354 nor Section 356 applies unless the transaction qualifies as a "reorganization" under one of the subsections of Section 368(a). *Turnbow* v. *Commissioner*, 368 U.S. 337 (1961). If the redemption in question was not part of a reorganization, as the Tax Court concluded, the treatment of the proceeds received in the redemption would be governed by Section 302 of the Code. See generally *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979). And, as the Tax Court demonstrated (Pet. App. 15a-16a), the amount received by petitioner

Petitioner's assertion (Pet. 12) that the decision below conflicts with other decisions applying the "step transaction doctrine"—namely, *Helvering* v. *Limestone Co.*, 315 U.S. 179 (1942); *McDonald's Restaurants* v. *Commissioner*, 688 F.2d 520 (7th Cir. 1982); and *King Enterprises, Inc.* v. *United States*, 418 F.2d 511 (Ct. Cl. 1969)—is wholly without merit. None of those cases remotely suggests that, contrary to the express terms of the Code, cash received in connection with a reorganization need not be recognized. Indeed, *King Enterprises* specifically held that the cash and promissory notes received in the reorganizations at issue there were to be treated as a dividend under Section 356. See 418 F.2d at 519-521.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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would be taxable as a dividend under Section 302—a conclusion that petitioner does not contest—because the redemption reduced petitioner's interest in Texas Plastics only from 93.3% to 89.2%, a reduction that obviously could not be characterized as "meaningful." See I.R.C. § 302(b)(1). On the other hand, if the redemption here was a part of a reorganization within the meaning of Section 368(a), as petitioner maintains and as the court of appeals assumed arguendo, the treatment of the redemption proceeds is governed by Section 356(a) of the Code. Under that provision, if the redemption had the effect of the distribution of a dividend, then the amount received by petitioner (to the extent of the gain realized) is taxed as a dividend. See *Shimberg* v. *United States*, *supra*. Petitioner makes no contention that the $419,680 it received was entitled to capital gain treatment, nor does it claim that its gain was less than the amount it received from the redemption. Rather, it flatly asserts that it need not recognize any income with respect to the redemption—an assertion that flies in the face of the express terms of Section 356.